

# BUSINESS ISSUES BULLETIN

47254

LAO PDR

THE BUSINESS INFORMATION CENTER AT THE LAO NATIONAL CHAMBER OF COMMERCE AND INDUSTRY

No. 7 December 2008

## Toward a Unified Investment Promotion Law Further enhancing the investment climate for growth

### Introduction

The first foreign investment law in Lao PDR was promulgated in 1989 following the government's adoption of the New Economic Mechanism reforms in the mid 1980s. In 1994, the law was amended to include provisions to allow for 100% foreign-owned businesses and to broaden the range of sectors open to foreign investment. The first domestic investment law was promulgated in 1995 to provide a framework for promoting investment by Lao-owned businesses.

Following a second round of revisions to the legal framework for investment in 2004, there are currently two laws governing domestic and foreign investment, namely the Domestic Investment Promotion Law and the Foreign Investment Promotion Law. Box 1 provides a timeline of the development of the legal framework for investment in the Lao PDR. The Government of Lao PDR is currently revising its legal framework for investment to further streamline procedures to reduce administrative burdens on investors. This Business Issues Bulletin highlights the major issues affecting the legal framework for investment and provides recommendations for reforms to streamline the role of the government in investment approval and strengthen its role in investment promotion and generation.

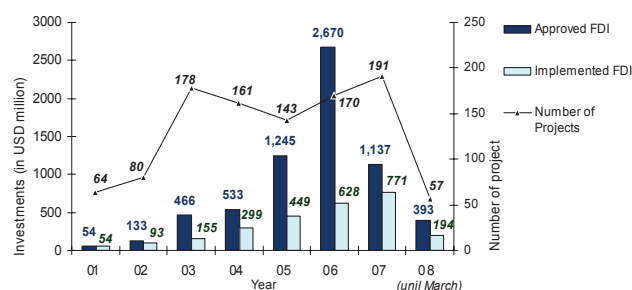
#### Box 1: Timeline of investment laws in Lao PDR

Foreign Investment	Domestic Investment
<b>1989:</b> Foreign Investment Law, No.07/PSA, dated April 19, 1989	
<b>1994:</b> Foreign Investment Law No.01/NA, dated March 14, 1994 (Amendments to FIL 1989)	<b>1995:</b> Domestic Investment Promotion and Management Law No.03/95/NA, dated Oct. 14, 1995
<b>2004:</b> Foreign Investment Promotion Law, no.11/NA, dated October 22, 2004	<b>2004:</b> Domestic Investment Promotion Law, No.10/NA, dated October 22, 2004

### Investment Situation in Lao PDR

As a result of a number of measures taken by the government to encourage foreign investment since the late 1980s, foreign direct investment (FDI) inflows have expanded and account for a higher share of total investment. Figure 1 shows the flow of approved and implemented FDI from 2001 to March 2008.

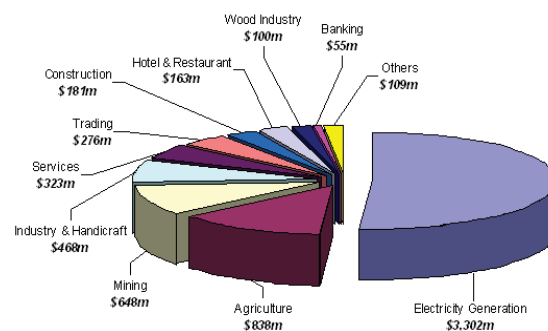
Figure 1: Approved and Implemented Foreign Investment 2001 to March 2008



Source: Ministry of Planning and Investment

As seen in Figure 2 below, the largest percentage of approved FDI since 2000 has been channeled to power generation projects followed by the agriculture, mining, and industry and handicraft sectors.

Figure 2: Approved Foreign Investment by Sector 2000 to March 2008



Source: Ministry of Planning and Investment



**International Finance Corporation**  
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This bulletin is published with support from IFC-managed MPDF, a private sector development initiative in Vietnam, Cambodia, and Lao PDR, whose donors are Australia, Canada, Finland, IFC, Ireland, Japan, New Zealand, the Netherlands, Norway, Sweden, and Switzerland.

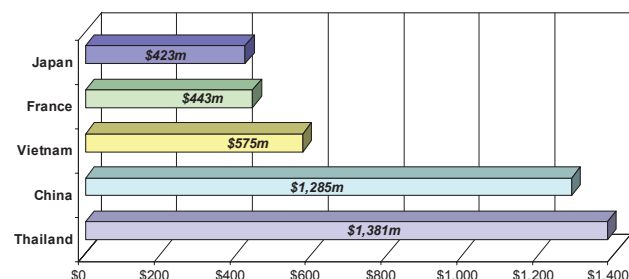
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Data from the same period indicate that Thailand is at the top of the list in terms of approved investment by country followed by Vietnam, China, France and Japan. However, as investment from China has increased rapidly during recent years, it will soon outpace Thailand as the largest investor.

Figure 3: **Approved Foreign Investment by Country of Origin 2000 to March 2008**



Source: Ministry of Planning and Investment

## Issues and Challenges

Although the trend of investment approval and implementation has increased steadily since 2000, a number of outstanding issues and challenges can still be observed, including:

- *Need to enhance sustainable investment in more diversified sectors.* As can be seen from Figure 2, foreign investment in Lao PDR is heavily concentrated in resource based sectors. It is very important for the government to encourage more investment in sectors such as manufacturing and services in order to achieve an appropriate level of diversification and create more employment. The current investment laws tend to target larger project-type investments rather than to promote firms to diversify in a wider range of business activities. To this end, the legal framework plays an essential role in promoting an enabling environment for business, for which Lao PDR is still ranked relatively low in the Doing Business Report of the World Bank Group. The legal framework should aim to better ensure equity, transparency, and predictability with adequate protections and guarantees in place for all investors.
- *Need to harmonize legal framework for investment with related laws.* The legal framework for investment needs to be aligned with recent improvements in other related laws, such as the Enterprise Law, Taxation Law and other sector-specific laws, as well as with international and regional arrangements, including WTO accession and the ASEAN Free Trade Agreement.
- *Need to enhance role of relevant government agencies in investment promotion.* It is understood that the current direction of the government and the Ministry of Planning and Investment (MPI) is to move toward playing a greater role as an investment promoter than as a regulator. Despite this trend, the current legal framework for investment focuses heavily on regulating and managing investment rather than strengthening the role of the government in generating investment. This aspect of the current legal framework needs strengthening in order to create a better separation between regulation and promotion.

## Key Areas for Reform

Recognizing the need to address these issues and challenges, the Government of Lao PDR has decided to prepare a new unified Law on Investment Promotion. As the government prepares this new law, there are several key areas for reform that should be addressed. These include:

- 1) *Unification of two existing laws on investment* – Based on international and regional good practices, investment laws should focus on applying a common set of rules that focus on the type of investment activities rather than on the nationality of the investors. The fundamental goal behind this practice is to ensure a level playing field for all investors regardless of their nationality. The new law under preparation addresses this issue and will be the first unified investment law the Lao PDR has ever issued.
- 2) *Harmonization of procedures for business entry* – As commonly known, a wide range of rules collectively affect and regulate investment in a particular country. Oftentimes, many of these rules lie outside the scope of an investment law and are part of the legal framework for business entry and operations. In the case of Lao PDR, the business entry rules belong to the legal and regulatory framework under the Enterprise Law. In preparing the new Law on Investment Promotion, it is very important that the contents of the revised law are well aligned with those in the Enterprise Law. Consistency is needed to ensure that as per the Enterprise Law, only those business activities within the Conditional List issued under the Enterprise Law require prior approval from sectoral agencies before registration. All other business activities should be allowed to proceed directly to the Ministry of Industry and Commerce for business registration.
- 3) *Liberalization of existing FDI specific restrictions* – In order to improve the overall climate for foreign investment, the first step usually taken by governments is to liberalize various FDI specific restrictions. In the current legal framework of the Lao PDR, several restrictions on foreign investment exist, which create artificial barriers to entry. Some of these include: i) a minimum requirement on foreign ownership in joint ventures (the current law requires foreign investors to hold at least a 30% share of any joint venture); minimum capital requirement (30% of total capital); and iii) local content requirements (such as maximum foreign labor of 10% or an obligation to give priority to recruiting Lao nationals). These restrictions should be removed in the new law.
- 4) *Rationalization of current incentive regime* – It is not uncommon that a country implements special measures in the form of incentives to encourage investors, especially tax incentives. During recent years, there has been a debate concerning the effectiveness of using tax incentives to promote investment, especially to attract FDI. Such incentives usually come with substantial costs in the form of tax revenue loss, additional administrative burdens, and the potential misuse of the incentive regime for tax avoidance by non-qualified projects. It has also been observed that tax incentives work best only when they are applied to tax-sensitive projects. Using tax incentives in other general projects, such as for resource-based industries merely results in a loss of

revenue since such investments would occur even in the absence of tax incentives.

In comparison to other countries in the region, the current tax incentive scheme of the Lao PDR is relatively generous and should be rationalized. Investors in a wide range of industries are provided with generous tax incentives, including a profit tax exemption period followed by a reduced rate which lasts indefinitely. These incentives are provided based on the expectation or promise from investors, rather than on their actual performance as measured by what they contribute to the economy in terms of employment or the introduction of new technology. In addition, the current incentive scheme in the Lao PDR is too complicated and ambiguous (in particular regarding the criteria for qualified investments and the authority of different administrative levels to grant incentives), causing significant administrative costs while leaving substantial room for discretion. In the end, it is not clear whether the current scheme incurs more costs than benefits to the country.

- 5) *Dispute resolution mechanism* – The current investment laws consist of provisions for dispute resolution that refer to relevant local settings including Committee for Promotion and Management of Investment (CPMI), the Economic Dispute Resolution Committee, and the People's Court. However, mechanisms often relied upon by larger more sophisticated investors, such as international arbitration, are not explicitly mentioned as options for resolving commercial disputes. Due to uncertainty in the host country perceived by foreign investors, most foreign investment laws provide recourse for dispute resolution via international arbitration mechanisms.
- 6) *Transitional provisions* – Another area that needs to be strengthened in the current legal framework for investment relates to the provisions necessary to ensure a smooth and equitable transition process for incentives that were granted under the earlier legal framework. Any changes to the incentive structure in the new law need to provide clear provisions to ensure that after some transitional period, all investors will be subject to the same scheme. It is important to ensure that investors carrying out the same business activities are not provided different incentives simply because of the regime that existed at the time of business start up. If the new law removes certain tax incentives that were provided under the old law without having specific transitional or grandfathering provisions, this would lead to inequity between existing investments and those that would be established under the new law.

The new law should include appropriate provisions that specify a reasonable approach and timeframe to adjust tax rates to the levels provided under the new investment promotion law.

- 7) *Emphasis on promotion and facilitation as key aspects of the revised law* – International experience suggests that the regulation and promotion of investment need to be treated as separate functions, which require a different set of skills serving distinctive objectives. Recognition of this distinction should be appropriately reflected in the new investment law.

Investment laws are increasingly being regarded by

governments as a promotional rather than regulatory tool. This means that the law should focus principally on laying down the rights of investors, protection measures, and the special treatment available for those investors meeting specific criteria. Good practice investment laws should outline key policy statements of the government with regard to the promotion of investment. These aim to attract investors by helping to create a level of comfort among them.

In the current investment laws in the Lao PDR, many provisions are heavily control-oriented including complicated screening procedures for entry, cumbersome monitoring schemes and reporting requirements and include highly subjective government authority to terminate the investment operations. While measures are needed in the law to approve investment incentives and monitor compliance with the investment incentive scheme, they should not be applied to the business operations of investors that are not related to the incentive scheme. Such provisions impose an unnecessary burden on investors to report on business operations to MPI on activities which are better regulated by relevant line ministries.

## Conclusion

A review of the investment laws in the Lao PDR issued since 1989 shows the intention of the Government to encourage private domestic and foreign investment and to continuously work on improving the related legal framework. The decision by the government to revise the two existing investment laws shows its intention to further address remaining deficiencies and incorporate more international norms and practices into a new unified investment law.

Improvements in the investment law and accompanying regulations are expected to have a positive impact on the investment climate by providing a secure legal foundation for investment in the country, simplifying business entry procedures, and clarifying the role of MPI as an investment generator and facilitator. If effective reforms are achieved through the new law it will be a positive step for the country in reaching its stated goal of attaining private investment of 22% of GDP, maintaining economic growth of 7-8% and, ultimately to graduate from the least-developed status by 2020.

## Viewpoints

*While recognizing the current increase in investment in large-scale projects in areas such as mining and hydropower, it continues to be a top priority for the government to create an investment climate that also supports small and medium enterprises, which are a major driver for economic development and job creation. To achieve this objective, the Government of Lao PDR has decided to revise the legal framework for investment by drafting a new unified investment law that aims to provide a secure legal framework that is comprehensive, transparent, and includes clear measures to protect investors and rationalize tax incentives.*

*Generally speaking, the design and use of investment incentives in developing economies such as Lao PDR*



are challenging tasks. They require balancing (i) effective targeting with (ii) equal treatment of competing enterprises and (iii) administrative efficiency, given the revenue needs and administrative capacities of the country. International experience shows that incentives are in many cases redundant. Investors in some sectors would have come regardless. Therefore, revenue is lost which could otherwise have been used to improve basic infrastructure and support national skills development.

The new investment law needs to ensure that the procedures for FDI entry are streamlined, foreign investors are protected, a level playing field is provided to investors regardless of origin, and the scope and type of incentives have the best chance of genuinely promoting investment in sectors with a sustainable future in Lao PDR. They should include investments with obvious spillovers to the broader economy. The incentives on offer should be timely in their assistance and equitable in their accessibility.

**Mr. Houmpheng Souralay, Director General,  
Investment Promotion Department, MPI**

One of the objectives of the reform of the investment law in Lao PDR is to simplify the entry of foreign and domestic investments and leave the regulation of the business operation to the sectoral ministries. The concerns are that not all sectors have their own laws regarding the licensing and regulation of business operations, or the existing laws refer to or reflect the rules or procedure defined in the existing foreign or domestic investment laws. As a result, the unification of the investment law should be the starting point for the reform of commercial laws and other laws related to investment to ensure consistency in the legal framework of the country.

Regarding foreign investment, the concerned government ministries should consider including provisions related to freedom to choose Law of Contract, Dispute Settlement, Accounting, Protection against Change in Law, and Stability of Fiscal Obligations. If Lao laws can not provide answers to these issues, foreign investors may try to negotiate and conclude specific agreements with concerned government agencies regarding these matters.

**Mr. Sivath Sengdoangchanh, Legal Expert  
on Commercial Laws**

The existing legal framework for investment is not suitable to encourage significant investment. It is bureaucratic, control-oriented, and inefficient. In this regard, the Lao Government has realized that the law drafting committee of Ministry of Planning and Investment seems to be heading in the right direction. I am hopeful that the overhaul of the investment regime will provide a more open and investor-friendly environment, which will in turn improve the country's competitiveness, contribute to more growth and generate employment.

**Mr. Marc Reichel, International Legal Expert  
on Commercial Laws**

Lao PDR has an opportunity to significantly improve on the current incentives component of the 2004 laws. The new law and its implementing decree can ensure that:

- all concessional tax treatment can be subject to time limits, with transition arrangements to ensure that existing beneficiaries' benefits do not indefinitely outstrip those on offer to new investors and distort competition.
- to access investment incentives, beneficiaries should be required to implement accounting standards that enable proper assessment of entitlements and tax obligations.
- there is no attempt to direct investors into costly use of 'local content' or to support 'import substitution' – the emphasis needs to be on international competitiveness.
- there is continuing relief for exporters from the distorting effects of duties and taxes on their inputs.
- tax incentives in the form of tax holidays are withheld from sectors where there is an obvious strong natural resource basis for highly profitable investment. Some risk sharing by government in the form of longer loss carry forward provisions is more appropriate.
- the case for retaining 'investment zones' as a basis for awarding bigger or smaller incentives has been adequately considered.

Ideally, reconfiguration of the incentives on offer would be done with some idea of what current tax holidays and indirect tax exemptions are costing. But reform is hampered by the fact that estimates have not been assembled of the fiscal impact of current concessions, many of which, like the 20% profit tax rate, are of indefinite duration. The reform task is also made harder because of the distorting effects of some remaining high tariff rates on a few products not made in Lao PDR and a profit tax rate (35%) that is high by regional standards. While beyond the scope of this legislation, medium-term reductions in these will help all investors and relieve the burden on incentives in encouraging investment."

**Mr. Ross Chapman, Investment Policy Expert**

There is an urgent need for much better communication between key government agencies whose activities impact on investment: for example between the Ministry of Planning and Investment and agencies within the Ministry of Finance such as the Taxation Department. Without improved coordination potentially beneficial reforms to the investment law may fail at both the design and implementation level. Furthermore, a sequence of past changes in investment law has left an uneven playing field that needs to be rectified. Changes to investment law between 1994 and the present, and to eligibility for tax holidays in particular, have left some businesses (for example foreign banks) on a 'permanent' preferential profit tax rate of 20 percent, while others (local and foreign banks) competing with them are paying the full statutory rate of 35 percent. An urgent adjustment needs to be made so all are competing on an equal footing.

**Mr. Kerrod Thomas, Managing Director,  
ANZ Vientiane Commercial Bank**